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May 31, 2013

Ms. Cynthia T. Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423

Re: STB Docket No. EP 558 (Sub-No. 16), *Railroad Cost of Capital—2012*

Dear Ms. Brown:

Pursuant to the decision served by the Board on February 26, 2013, attached please find the Rebuttal Comments of the Association of American Railroads (AAR) in the above captioned proceeding.

Respectfully submitted,

Timothy J. Strafford
Counsel for the Association of
American Railroads

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 558 (Sub-No. 16)

RAILROAD COST OF
CAPITAL — 2012

REBUTTAL COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS
AND ITS MEMBER RAILROADS

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May 31, 2013

BEFORE THE
SURFACE TRANSPORTATION BOARD

RAILROAD COST OF CAPITAL — 2012	)	STB Docket No. EP 558 (Sub-No. 16)

REBUTTAL COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS AND ITS MEMBER RAILROADS

By an order served on February 26, 2013, the Surface Transportation Board ("Board") instituted this proceeding to determine the railroad industry's cost of capital for the year 2012. In its order, the Board sought comment "on the following issues: (1) the railroads' 2012 current cost of debt capital; (2) the railroads' 2012 current cost of preferred equity capital (if any); (3) the railroads' 2012 cost of common equity capital; and (4) the 2012 capital structure mix of the railroad industry on a market value basis." *Railroad Cost of Capital – 2012*, EP No. 558 (Sub-No. 16) (STB served Feb. 26, 2013).

On April 19, 2013, the railroads, through the Association of American Railroads ("AAR"), submitted their calculation of the 2012 cost of capital using the methodology specified by the Board. The AAR calculated the railroads' overall cost of capital for 2012 at 11.06 percent, including a cost of common equity of 13.33 percent and a cost of debt of 3.29 percent.

On May 10, 2013, the Western Coal Traffic League ("WCTL") filed reply comments. WCTL did not challenge any aspect of the AAR's calculations, but instead repeated its objection to the Board's inclusion of a multi-stage discounted cash flow ("MSDCF") model in its cost of capital methodology. As the Board has made clear, reply comments that address issues outside the scope the annual cost of capital proceeding (including proposals for changes the methodology adopted by the Board) are improper and should not be considered by the Board. In these rebuttal comments, the AAR responds to WCTL's reply comments merely to highlight that the Board has consistently applied this rule and that WCTL's unsupported attacks on the Morningstar/Ibbotson MSDCF model fail. For the reasons discussed below, WCTL's challenges to the AAR's 2012 cost of capital calculations are without merit and should be rejected.

Discussion

I. WCTL's Collateral Attacks on the Board's Established Cost of Equity Methodology are Beyond the Scope of This Proceeding

WCTL should not be permitted to collaterally attack the Board's decision to include the Morningstar/Ibbotson MSDCF model in its estimate of the railroad industry's cost of equity. After a multi-year review of the appropriate methodology to calculate the railroad industry's current cost of capital, the Board adopted its established methodology of calculating the railroad industry's cost of equity as the simple average of the Capital Asset Pricing Model ("CAPM") and the Morningstar/Ibbotson MSDCF model in 2009. *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital*, EP No. 664 (Sub-No. 1)(STB served Jan. 28, 2009)("*Cost of Capital Methodology*"). The Board concluded that it should utilize an estimate of the cost of equity from both CAPM and a MSDCF model because "using multiple models will improve estimation techniques when each model provides new information," and "there is robust economic literature confirming that, in many cases, combining forecasts from different models is more accurate than relying on a single model." *Id.* at 15. The Morningstar/Ibbotson MSDCF model met the Board's criteria for a suitable MSDCF model and the Board found that the commercially available Morningstar/Ibbotson MSDCF model was appropriate because a "Wall Street measure can be instructive when the task is to measure the cost of equity, and this is a commercially accepted model, developed by disinterested, respected third parties, created for use by the financial community in evaluating publicly traded companies and in making real-world investment decisions." *Id.* at 7.

WCTL has consistently objected to the inclusion of the MSDCF in the cost-of-capital determination because under current economic conditions, it produces a higher result than CAPM. *See* WCTL Reply at 1; *see also* WCTL Comments, EP No. 664 (Sub-No. 1) at 3 (filed Sept. 15, 2008). But as the Board has repeatedly stressed, the annual cost of capital proceeding is not the proper forum for a party to propose changes to the Board's established cost of capital methodology. As expressly emphasized by the Board:

> We have established a procedural framework whereby in the Ex Parte No. 558 sub-numbered proceedings (558 proceedings) to determine the annual cost-of-capital figure, we are limited to applying the cost-of-capital methodology in place at the time, as determined in the Ex Parte No. 664 proceeding (664 proceeding). See Methodology To Be Employed In Determining The Railroad Industry's Cost Of Capital, STB Ex Parte 664, slip op. at 18 (STB served Jan. 17, 2008) (Cost of Capital CAPM). Proposed changes to the cost-of-capital model will be entertained only in the 664 proceeding. This allows the Board to complete its annual cost-of-capital determination in a timely manner and to provide all stakeholders with a meaningful opportunity to comment on any proposed methodological changes. Id. at 18.
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> We will not consider here the arguments presented by WCTL or AECC challenging our cost-of-capital methodology. It is settled administrative law that an agency need not, and as a matter of sound procedure should not, permit parties to relitigate generic rules in individual proceedings that apply those rules. See New Jersey Dept. of Environ. Protection v. NRC, 561 F.3d 132 (3d Cir. 2009) (state agency's attempt to relitigate generic environmental findings in an individual NRC proceeding amounted to a collateral attack on the NCR's licensing renewal regulations); Massachusetts v. NRC, 522 F.3d 115, 129-130

> (1st Cir. 2008) (NRC reasonably refused to allow a state to intervene in an individual licensing proceeding to relitigate issues decided in a separate generic proceeding); Tribune Co. v. FCC, 133 F.3d 61, 68 (D.C. Cir. 1998) ("An agency need not – indeed should not – entertain a challenge to a regulation, adopted pursuant to notice and comment, in an adjudication or licensing proceeding"). Under our rules, WCTL and AECC must raise any challenges to our cost-of-capital methodology in a petition for a rulemaking. See Cost of Capital CAPM at 18 ("While in the past we have entertained challenges to the agency's model in the 558 proceedings, we will no longer do so. As such, future requests to [change our methodology] must be brought (in the form of a petition for rulemaking) in a 664 proceeding, not in the annual 558 proceeding, in which we calculate the cost of capital for a particular year.").

Railroad Cost of Capital—2008, EP No. 558 (Sub-No. 12) (STB served Sept. 25, 2009), Slip Op. at 2. The Board has consistently applied this rule and rejected WCTL's attempts to relitigate issues related to the Board's methodology in the annual cost of capital determination. *See, e.g.*, *Railroad Cost of Capital—2010,* EP No. 558 (Sub-No. 14) (STB served Oct. 3, 2011), Slip Op. at 8; *Railroad Cost of Capital—2011,* EP No. 558 (Sub-No. 15) (STB served Sept. 13, 2012), Slip Op. at 17. As in these past cost-of-capital proceedings where the Board's admonishment to the parties against proposing methodological changes in the annual cost of capital proceeding was ignored, WCTL's challenge to the Board's cost-of-capital methodology should be given no consideration by the Board here.

II. WCTL Has Failed to Establish That the Morningstar/Ibbotson MSDCF Model Is Flawed

Notably, WCTL does not argue that the AAR erred in its calculations or did not apply the Morningstar/Ibbotson MSDCF model correctly. Nor could it. In its opening comments, the AAR applied the Board's established methodology to calculate a MSDCF cost of equity in the same way it did with the Board's approval as "correct and consistent with the Board's approved methodology," in last year's cost of capital proceeding. *Railroad Cost of Capital—2011,* EP No. 558 (Sub-No. 15) at 13. The Board has expressly stated that:

> In the first stage (years one through five), the firm's annual earnings growth rate is assumed to be the median value of the qualifying railroad's three- to five-year growth estimates as determined by railroad industry analysts and published by Institutional Brokers Estimate System (I/B/E/S). In the second stage (years six through ten), the growth rate is the average of all growth rates in stage one. In stage three (years 11 and onwards), the growth rate is the long-run nominal growth rate of the U.S. economy.

Id. The AAR correctly used the I/B/E/S estimates of growth rates and calculated the cost of equity using the MSDCF model.

WCTL attempts to discredit the Morningstar/Ibbotson MSDCF model by noting that the railroad analyst growth projections are expressed in terms of earnings per share.[1] WCTL then asserts that the Morningstar/Ibbotson MSDCF model is flawed because the number of shares outstanding in the marketplace can affect the calculation of earnings per share, all other things being held constant. WCTL Reply at 3. WCTL's claim fails for three reasons.

First, WCTL's collateral attack on the Board's approved methodology is unsupported. The Board has previously admonished WCTL that critiques of the Morningstar/Ibbotson MSDCF that are not supported by expert testimony are suspect. "WCTL has raised a number of complex critiques of an established model by a reputable commercial vendor, yet counsel's argument is not the same as substantive testimony by expert witnesses, particularly on these kinds of highly technical finance matters." *Cost of Capital Methodology* at 8. The Board cannot rely on counsel's argument in this proceeding to depart from its established methodology established in a notice and comment rulemaking.

Second, WCTL's statement that "reducing shares causes EPS to increase faster than

[1] It is difficult to understand how the WCTL review of the 2012 cost of capital evidence "revealed" that growth rates used in the Morningstar/Ibbotson MSDCF model are expressed in terms of earnings per share, when WCTL has been arguing about the growth rates in the MSDCF since 2008. *See, e.g.,* WCTL Comments, EP No. 664 (Sub-No. 1) (filed Sept. 15, 2008).

overall earnings when earnings increase," WCTL Reply at 2, is of limited insight. While factually accurate, it does not in any way lead to the conclusion that WCTL asks the Board to draw – that the Board should discard the rule it adopted through notice and comment rulemaking because of a flaw in the Morningstar/Ibbotson MSDCF model. It is equally true that reducing shares would cause EPS to decrease faster than overall earnings if earnings decrease. And the numbers of shares available are not always going to be reducing. There are economic conditions that cause prudent firms to increase the numbers of shares in the marketplace. When that occurs, EPS will increase at a slower rate than overall earnings. The Board should not consider altering its methodology simply because current economic conditions do not favor WCTL.

Finally, the Board adopted the Morningstar/Ibbotson MSDCF model as part of its cost of equity estimate because it was a transparent, commercially available product utilized by the investment community. The investment professionals at Morningstar/Ibbotson, "a leading provider of independent investment research,"[2] utilize growth rates developed by railroad industry analysts to project short-term growth and estimate future cash flows. WCTL has not demonstrated that the analysts who predict growth rates do not take into account the effects of stock issuances or repurchases on earnings per share in the future or otherwise cannot be relied on. Therefore, the Board should not depart from its established methodology.

In sum, WCTL has not provided any basis for the Board to conclude that the Morningstar/Ibbotson MSDCF model is in any way flawed.

[2] WCTL Reply Comments, EP No. 558 (Sub-No. 9) (filed April 28, 2006) at 9.

Conclusion

The Board should determine that the railroads' cost of capital for 2010 is 11.57 percent.

Respectfully submitted,

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Counsel for the Association of American Railroads
and Member Railroads

May 31, 2013

CERTIFICATE OF SERVICE

I hereby certify that on this 31st day of May, 2013, I served by first class mail, postage prepaid, a copy of the forgoing on the following:

Robert D. Rosenberg
Slover & Loftus
1224 Seventeenth St, NW
Washington, DC 20036-3003

Rosita N'Dikwe

Rosita N'Dikwe